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No. 80-2015

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

ASARCO INCORPORATED (formerly The American Smelting and Refining Company), *Appellant*,

v.

IDAHO STATE TAX COMMISSION, *Appellee*.

Appeal from the Supreme Court of Idaho

BRIEF OF APPELLANT

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QUESTIONS PRESENTED

1. Whether, under the "unitary business" test set forth by this Court in *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), Idaho's inclusion in appellant's apportionable business income of dividends paid to appellant by five functionally independent subsidiaries and affiliates contravenes the Due Process Clause of the Fourteenth Amendment to the Constitution of the United States.

2. Whether Idaho's inclusion in appellant's apportionable business income of interest and capital gains attributable to appellant's investments in such subsidiaries and affiliates contravenes the Due Process Clause.

3. Alternatively, whether Idaho's inclusion of the foregoing dividends, interest, and capital gains in appellant's apportionable business income, without a correlative adjustment in the apportionment factors, contravenes the Due Process Clause.

4. Alternatively, whether Idaho's inclusion of certain foreign-source dividends and interest in appellant's apportionable business income, without a correlative adjustment in the apportionment factors, contravenes the Foreign Commerce Clause of Article I, Section 8 of the Constitution.

SUBSIDIARIES AND AFFILIATES OF APPELLANT

As required by Rule 28.1 of the Rules of this Court, a list of appellant's subsidiaries (other than wholly owned subsidiaries) and affiliates is set forth in the Jurisdictional Statement filed in this case. That list is still accurate, except that (1) M.I.M. Holdings, Ltd., a company named therein, has acquired significant stock interests in Evans Deakin Industries Limited and Bush Pilots Airways, Ltd., two publicly owned Australian companies, and (2) appellant sold 30% of its stock in Geominerals, Inc. in October, 1981, thereby reducing its stock ownership to less than 100%.

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v.

IDAHO STATE TAX COMMISSION, *Appellee.*

Appeal from the Supreme Court of Idaho

BRIEF OF APPELLANT

OPINIONS BELOW

The second opinion of the Supreme Court of the State of Idaho (the "Idaho Supreme Court"), from which this appeal is now taken, is unofficially reported as *Am. Smelting & Refining* v. *Idaho St. Tax Com'n,* 624 P.2d 946 (Idaho 1981). That opinion simply reinstated, following a remand from this Court, the initial opinion of the Idaho Supreme Court which is reported as *Am. Smelting & Refining* v. *Idaho St. Tax Com'n,* 99 Idaho 924, 592 P.2d 39 (1979). Included as Appendix A to the Jurisdictional Statement[1]

[1] The Jurisdictional Statement filed in this case contains six appendices, herein referred to as "J.S.App.A" through "J.S. App. F." The pages in the six appendices are consecutively numbered. Where appropriate, references to these appendices will be followed by a page number indicating the location of the cited material in the appendices as a whole.

The separately bound joint appendix filed by the parties to this appeal will be referred to as the "J.A."

The three appendices attached to this brief will be referred to as "App.A, *infra*" through "App.C, *infra.*"

are copies of: the second opinion of the Idaho Supreme Court on remand from this Court (J.S.App.A 1a-2a); the order of this Court, which is reported at 445 U.S. 939 (1980), vacating the first judgment of the Idaho Supreme Court and remanding the case for further consideration (J.S.App.A 3a); the first opinion of the Idaho Supreme Court (J.S.App.A 4a-35a); the unreported Memorandum of the District Court of the Fourth Judicial District of the State of Idaho, Ada County (the "State District Court") (J.S.App.A 36a-37a); the unreported Findings and Conclusions of the State District Court (J.S.App.A 38a-45a); and the unreported Decision of the Idaho State Tax Commission (J.S.App.A 46a-62a).

JURISDICTION

On March 4, 1981, the Idaho Supreme Court rendered its second decision, from which this appeal is taken, upholding the constitutionality of the Idaho taxing statute as applied to appellant. This appeal was docketed within 90 days of that date on May 29, 1981. This Court noted probable jurisdiction on October 5, 1981. (J.A. 139a) This Court has jurisdiction under 28 U.S.C. § 1257(2); see *Cox Broadcasting Corp.* v. *Cohn*, 420 U.S. 469 (1975).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Commerce Clause (Art. I, § 8, cl. 3):

> Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

Due Process Clause (Amend. XIV, § 1):

> [N]or shall any State deprive any person of life, liberty, or property, without due process of law;

Section 63-3027 of the Idaho Code ("I.C.") is set forth in J.S.App.D 67a-74a.

Sections 128A, 128B, and 221YL of the Income Tax Assessment Act 1936, as amended by Act No. 85, Acts of the Parliament of the Commonwealth of Australia (1967); and Articles 60 I and V, 61, 66, 73 I and 74 of the Income Tax Law of Mexico, as in effect in the years 1968-1970, are set forth in App. A, *infra*.

STATEMENT OF THE CASE

ASARCO Incorporated, the appellant, is engaged in the business of mining, smelting, refining, and selling nonferrous metals (hereinafter referred to as appellant's "Unitary Business"). Appellant is incorporated in New Jersey, maintains its headquarters or "commercial domicile" in New York, and conducts business in a number of other States, including Idaho. Appellant's principal business in Idaho is mining silver. In addition, appellant mines lead and zinc, operates the administrative office for its northwest mining division, and sells small amounts of secondary metals in Idaho. Appellant's smelting, refining, and other activities are conducted elsewhere. (J.S.App.A 39a-41a; J.A. 54a)

During the years in issue, 1968 through 1970, appellant received sizable dividends from M.I.M. Holdings, Ltd. ("M.I.M."), General Cable Corporation ("General Cable"), Revere Copper and Brass, Incorporated ("Revere"), ASARCO Mexicana, S.A. ("Mexicana"), and Southern Peru Copper Corporation ("Southern Peru"). Appellant also received interest on Revere's convertible debentures, on a note received in connection with a prior sale of Mexicana stock, and on a note received in connection with a 1970 disposition of General Cable stock. In addition to the capital gain which appellant realized on the General Cable stock disposition, appellant realized capital gains in 1968 and 1969 on the sale of a small part of its M.I.M. stock. Appellant also received other income from intangibles during the years in issue. However, for purposes of this appeal, appellant is limiting its constitutional challenge to

Idaho's treatment of the foregoing dividends, interest, and capital gains.[2]

M.I.M. is a major publicly owned corporation engaged in mining, milling, smelting, and refining nonferrous metals. It does business both in Australia and in England. During the years in issue, appellant owned approximately 53% of the stock of M.I.M., with the balance of the stock being widely held. Appellant had no representatives on the M.I.M. Board of Directors and the two companies had no common directors or common officers. In addition, there were no significant business transactions between the two corporations. M.I.M. operated "entirely independently" of appellant and had only "minimal contact" with appellant. (J.S. App.A 8a, 43a; J.A. 34a, 40a, 132a-135a)

General Cable and Revere are engaged in the metal fabricating or manufacturing business which is a business not conducted by appellant. During the taxable years in issue, appellant owned approximately 34% of the stock of each of these corporations, but appellant had no representatives on their Boards of Directors, no common directors, and no common officers. An antitrust decree prohibited appellant from even voting its stock in these corporations. While both companies purchased substantial amounts of copper from appellant, the antitrust decree expressly prohibited appellant from selling copper to them at prices lower than those charged to competitors. As required by the antitrust decree, appellant ultimately disposed of its General Cable stock. Following this disposition in 1970, appellant continued to sell copper to General Cable on the same basis as it had previously. (J.S.App.A 8a-9a, 39a; J.A. 35a, 40a, 50a, 135a-137a)

During the years involved, appellant owned 49% of the stock of Mexicana. Mexican law effectively prohibited the ownership of any greater percentage. Appellant did not control Mexicana or dictate its policy; Mexicana acted in-

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[2] A schedule showing all of appellant's dividends, interest income, and capital gains during the years in issue is set forth at J.A. 51a-53a.

dependently of appellant. There were no common officers of the two companies. While Mexicana was engaged in the same general line of business as appellant, the only intercompany sales between the two corporations were some spot purchases of concentrates by appellant from Mexicana. Appellant also performed some miscellaneous technical services for Mexicana, but appellant was compensated for these services on an arm's length basis. (J.S.App.A 9a-10a, 43a; J.A. 128a-132a)

During the years involved, appellant owned 51.5% of the stock of Southern Peru, but, pursuant to the terms of an agreement with the other shareholders of Southern Peru, appellant could not exercise control of the corporation. Under the agreement, which was incorporated in Southern Peru's by-laws, appellant could appoint only six of the 13 directors. Southern Peru was engaged in mining and smelting copper in Peru. Approximately 35% of the copper it produced was sold to appellant. The remaining production was sold to various buyers—30% to buyers in Europe and the balance to the other shareholders. All of the sales were made at arm's length prices. Southern Peru had its own operating staff and appellant received a fee for the incidental technical services which it provided. (J.S.App.A 7a-8a, 43a; J.A. 121a-128a)

The parties stipulated that M.I.M., Mexicana, and Southern Peru made no sales or purchases in Idaho, had no representatives or agents in Idaho, and conducted no business activity in Idaho during the years in issue. (J.A. 49a) There was no evidence or assertion that General Cable or Revere conducted any business in Idaho.

In filing its Idaho tax return for 1969 and 1970, appellant apportioned its operating business income between sources within and without Idaho on the basis of the three-factor formula prescribed pursuant to I.C. § 63-3027. See J.S. App.D 71a-73a.[3] This three-factor formula attributed to

[3] For 1968, appellant reported its Idaho tax using a separate accounting, rather than an apportionment, method. (J.A. 26a)

Idaho that fraction of appellant's total "business income" which was the average of the ratios of appellant's tangible property, payroll, and sales in Idaho to its total tangible property, payroll, and sales everywhere. Appellant did not include any of the dividends, interest, or capital gains in issue here in its apportionable business income.[4] As a result, appellant's Idaho taxable income for 1969 and 1970 was reported as $419,876 and $127,755, respectively. (J.A. 105a, 113a)

In 1971, the Multistate Tax Commission ("MTC") completed an audit of the years involved on behalf of Idaho and five other States. The MTC auditor made several significant adjustments. First, pursuant to I.C. § 63-3027(s) (J.S.App.D 73a), the MTC auditor treated appellant and six of its wholly owned subsidiaries as a single corporation and determined appellant's Idaho taxable income accordingly. Under this combined apportionment method, the incomes and apportionment factors of all of the combined corporations were taken into account and dividends paid by the six subsidiaries were disregarded. (J.S.App.A 6a)

The MTC auditor also determined that all of appellant's other dividends, together with its interest and capital gains, were includable in appellant's apportionable business income. The combined effect of all of the auditor's adjustments was to increase appellant's Idaho taxable income to $2,274,750 in 1969 and $2,162,346 in 1970. Because appellant's dividends, interest, and capital gains were so large, the major portion of the auditor's adjustment was attributable, in each instance, to the inclusion of those items in apportionable business income. (J.S.App.A 6a-11a; J.A. 67a, 75a)

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[4] Appellant also excluded certain other income from intangibles. The Idaho Supreme Court held (J.S.App.A 24a-25a) that some of those other items were apportionable, and appellant has not appealed with respect to those items.

Appellant challenged the inclusion of the dividends, interest, and capital gains in its apportionable business income on both statutory and constitutional grounds.[5] The Idaho State Tax Commission rejected both of these challenges. (J.S.App.A 53a-62a) The State District Court upheld appellant's statutory argument without reaching the constitutional issues. (J.S.App.A 36a-37a, 44a-45a) The Idaho Supreme Court reversed, however, rejecting most of appellant's statutory arguments[6] (J.S.App.A 12a-26a) and all of its constitutional arguments (J.S.App.A 26a-33a). Appellant appealed to this Court, which vacated the judgment of the Idaho Supreme Court and remanded the case "for further consideration in light of" *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980). (J.S.App.A 3a) On remand, however, the Idaho Supreme Court simply reinstated its first opinion. (J.S.App.A 1a-2a) Accordingly, appellant appeals for the second time to this Court.

SUMMARY OF ARGUMENT

1. *Exclusion of Dividends from Apportionable Income:* Prior decisions of this Court permit a nondomiciliary State to use a formulary apportionment method to determine the income tax liability of a corporation doing business both inside and outside the State. However, this approach is permissible only if and to the extent that the income being apportioned is derived from a "unitary business" in which the activities being conducted outside the taxing State are functionally integrated with the activities being conducted inside the State.

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[5] Initially, appellant also challenged the auditor's use of combined reporting. That issue, however, was resolved against appellant at the trial level, was not appealed, and is no longer in the case.

[6] The Idaho Supreme Court did hold that a small portion of appellant's dividend income constituted nonbusiness income which was not subject to apportionment under the Idaho Code. (J.S. App.A 23a)

In such cases, the State is permitted to tax a fairly determined fractional part of the total income earned by the enterprise as a whole, because there may be no other way of identifying and separately accounting for the profits generated by the activities within the taxing State. However, where there are operations outside the taxing State which are functionally discrete, and can therefore be separately accounted for, apportionment with respect to those operations is neither necessary nor appropriate. If the out-of-state activities do not contribute in some meaningful way to the production of income within the State, the State has no legitimate interest in taxing *any* portion of the income earned from those out-of-state activities.

In *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the Court made it clear that the foregoing "functional integration" test applies to dividends which a corporation doing business within the State receives from other corporations operating exclusively outside the State. Under *Mobil*, the dividends may be included in the apportionable income of the recipient only if the out-of-state activities of the payor are so closely related, in a functional sense, to the in-state activities of the recipient that all of those activities constitute a single "unitary business."

In the present case, the dividends, interest, and capital gains which appellant received from its long-term investments in five out-of-state corporations were not properly includable in appellant's apportionable income for Idaho tax purposes because all five corporations were independently managed, separately operated, free-standing concerns. Several of them had no significant business dealings with appellant, and those that did were customers or suppliers who dealt with appellant on the same arm's length basis as appellant dealt with other third parties. The profits earned by the five companies and distributed to appellant had nothing to do with appellant's Idaho activities and should therefore not be included in the Idaho tax calcula-

tion. Appellant's interest income and capital gains stand on the same conceptual footing and should be excluded from apportionable income for the same reasons.

2. *Modification of Apportionment Factors:* If this Court nevertheless holds that any or all of the foregoing dividends, interest, or capital gains may constitutionally be included in appellant's apportionable business income, the Idaho tax will still contravene the Due Process Clause, and also the Foreign Commerce Clause, unless Idaho adjusts its regular apportionment formula to reflect the out-of-state property, payroll, and sales which generated the profits being included in appellant's apportionable income base.

In *Mobil*, this Court held that the apportionability of income the taxpayer receives from unitary business activities should not be affected by whether the income comes in the form of divisional profits or dividends from legally separate entities. This Court stated (445 U.S. at 441) that transforming divisional profits into dividends "works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives."

If the income which appellant received in the form of dividends from corporations operating outside Idaho had constituted profits of unitary divisions being operated by appellant outside Idaho, there is no question that the out-of-state property, payroll, and sales of the divisions would have been taken into account in appellant's apportionment factors. Idaho's failure to reduce the apportionment fraction to reflect out-of-state property, payroll, and sales of the dividend-paying corporations violates the Due Process Clause because it inevitably overstates the portion of appellant's total income which is attributable to its Idaho property, payroll, and sales.

Idaho's failure to adjust the apportionment factors also violates the Foreign Commerce Clause by permitting Idaho to impose a direct tax on foreign-source investment income that has already been taxed by foreign governments. In

accordance with international custom, the laws and treaties of this Nation explicitly provide that the Federal Government will avoid double taxation of foreign-source investment income by allowing United States taxpayers to credit their foreign tax payments on such income against their federal tax liability. Consequently, Idaho's failure to use some mechanism that will avoid double taxation at the state level prevents this Nation from speaking with one voice in matters affecting commercial relations with foreign countries.

ARGUMENT

I. UNDER *MOBIL*, IDAHO'S INCLUSION OF THE DIVIDENDS, INTEREST, AND CAPITAL GAINS IN APPELLANT'S APPORTIONABLE BUSINESS INCOME CONTRAVENES THE DUE PROCESS CLAUSE.

Because it operates a mine and has an office in Idaho, appellant agrees that it is subject to tax in Idaho on that portion of the income from its Unitary Business which is properly attributable to its Idaho activities. Appellant also agrees that Idaho may use a formulary apportionment method (rather than separate accounting) to determine the portion of appellant's Unitary Business income which is properly attributable to its Idaho activities. *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) (hereinafter "*Mobil*"); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267 (1978). Appellant submits, however, that, under the Due Process Clause, the dividends, interest, and capital gains at issue here may not be included in the Unitary Business income which is subject to apportionment.

A. This Court's Decision in *Mobil*.

The threshold issue in *Mobil* was whether, under the Due Process Clause, a nondomiciliary State (Vermont) could constitutionally tax (by inclusion in apportionable income) certain dividends received by a resident corporation (Mo-

bil) from nonresident payor corporations having no contact with the taxing State.[7] Although the record in the *Mobil* case failed to provide much detail, this Court made the key finding that (445 U.S. at 435):

> [I]t is apparent, from perusal of such documents in the record as appellant's corporate reports for the years in question, that many of these subsidiaries and affiliates, including the principal contributors to appellant's dividend income, engage in business activities that form part of Mobil's integrated petroleum enterprise. Indeed, although appellant is unwilling to concede the legal conclusion that these activities form part of a "unitary business," see Reply Brief for Appellant 2, n. 1, it has offered no evidence that would undermine the conclusion that most, if not all, of its subsidiaries and affiliates contribute to appellant's worldwide petroleum enterprise.

On this basis, this Court upheld Vermont's power to include the dividends paid by these subsidiaries and affiliates in Mobil's apportionable income, stating (445 U.S. at 439):

> [T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle. In accord with this principle, what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State. *Bass, Ratcliff & Gretton* [266 U.S. 271 (1924)] forecloses the contention that the foreign source of the dividend income alone suffices for this purpose. Moreover, appellant has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct

[7] As used hereinafter, the term "resident" corporation means a corporation which is doing business within the taxing State, but is organized under the laws of some other State and has its headquarters or commercial domicile in some other State. Since appellant has its legal domicile in New Jersey and its commercial domicile in New York (J.A. 54a), and does business in Idaho, appellant is a resident of Idaho.

> in any business or economic sense from its petroleum sales activities in Vermont. Indeed, all indications in the record are to the contrary, since it appears that these foreign activities are part of appellant's integrated petroleum enterprise. [Footnote deleted.]

This Court also stressed that the form of business organization should have no impact on the outcome, stating (445 U.S. at 440-441):

> Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company function. So long as dividends from subsidiaries and affiliates reflect profits derived from a functionally integrated enterprise, those dividends are income to the parent earned in a unitary business. One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.
>
> Superficially, intercorporate division might appear to be a more attractive basis for limiting apportionability. But the form of business organization may have nothing to do with the underlying unity or diversity of business enterprise. Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington*, 377 U.S. 436, 441 (1964). Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives. [Footnote deleted.]

In addition, at a later point in the opinion, the Court explicitly confirmed that it had based its decision on the relationship between Mobil's activities and those of the payor corporations, stating (445 U.S. at 442):

> Where the business activities of the dividend payor have nothing to do with the activities of the recipient

in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business. We need not decide, however, whether Vermont's tax statute would reach extraterritorial values in an instance of that kind. Cf. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S., at 121. Mobil has failed to sustain its burden of proving any unrelated business activity on the part of its subsidiaries and affiliates that would raise the question of nonapportionability. [Citations and footnote deleted.]

B. Under the "Unitary Business" Test of *Mobil*, the Issue Is Whether the Activities of the Dividend-Paying Corporation and Those of the Recipient in the Taxing State Are Part of a Single Functionally Integrated Business.

The foregoing quotations from the Court's opinion make it plain that the unitary business test adopted in *Mobil* is whether the "underlying activity"—that is, the *business activity of the dividend-paying corporation*—is part of a "functionally integrated enterprise" being conducted, in part, by the recipient corporation in the taxing State. In other words, the test is whether the activities of the dividend-paying corporation and the activities of the recipient in the taxing State are part of the same functionally integrated, unitary business.

The reason for this "functional integration" requirement becomes obvious when one bears in mind the purpose of formulary apportionment. As this Court has recognized on many occasions, the need for formulary apportionment arises in cases such as this because of (1) the constitutional requirement that a nondomiciliary State tax only the income from the resident corporation's in-state activities, and (2) the difficulty in determining such income where the resident corporation conducts an integrated, unitary business both within and without the taxing State. See, *e.g.*, *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, *supra* (integrated petroleum business); *Mobil*, (integrated petroleum business); *Moorman Mfg. Co.* v. *Bair*, *supra* (integrated

manufacture and sale of animal feeds); *Butler Bros.* v. *McColgan*, 315 U.S. 501 (1942) (integrated wholesale business); *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U.S. 271 (1924) (integrated manufacture and sale of ale); and *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920) (integrated manufacture and sale of typewriters). In such cases, the State is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Underwood Typewriter Co.* v. *Chamberlain, supra*, 254 U.S. at 121. But such allocation is "impossible" only where the in-state and out-of-state activities are so closely tied together that the income is earned by the entire enterprise as a unit; in such cases, as this Court noted in *Mobil* (445 U.S. at 438):

> [S]eparate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. *Butler Bros.* v. *McColgan*, 315 U.S., at 508-509. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source."

By comparison, where two activities of a corporation, or the activities of a parent corporation and its subsidiary, are functionally discrete, separate accounting will suffice to determine the income from each separate activity and there is no need for apportionment.

The foregoing analysis has been uniformly recognized by this Court in its apportionment decisions. For example, in *Adams Express Co.* v. *Ohio State Auditor*, 165 U.S. 194 (1896), the Court noted that unity of ownership alone was insufficient to justify apportionment, stating (165 U.S. at 222):

> The same party may own a manufacturing establishment in one state and a store in another, and may make profit by operating the two, but the work of each is separate. The value of the factory in itself is not conditioned on that of the store, or *vice versa*, nor is

> the value of the goods manufactured and sold affected thereby. The connection between the two is merely accidental and growing out of the unity of ownership.

By comparison, where the store sells the products manufactured by the factory, the operations of the two become functionally integrated and apportionment is appropriate. Thus, in *Bass, Ratcliff & Gretton* v. *State Tax Commission, supra*, this Court stated (266 U.S. at 282):

> So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions, beginning with the manufacture in England and ending in sales in New York and other places,—the process of manufacturing resulting in no profits until it ends in sales,—the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business.

Similarly, apportionment may be appropriate where there is horizontal rather than vertical integration. See, *e.g.*, *Butler Bros.* v. *McColgan, supra*, where wholesale stores in several States were operated in an integrated fashion by utilizing a central buying division, a central advertising division, and centralized executive management.[8]

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[8] Keesling and Warren, in their article *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 42, 50-52 (1960), refer to vertical integration as "operational unity" and horizontal integration as "economic unity." It is clear that the authors believe separate activities will comprise a "business" only if one of these two unities is present. As we have done above, they relate this definition of a "business" to the circumstances where income apportionment is appropriate. Thus, they conclude (p. 49):

> Briefly stated, for the purposes of allocation of income, a business may be defined as a separately owned group of activities each of which contributes to the production or earning of a given identifiable item of income, no portion of which can be segregated and specifically identified as being attributable to any one of the activities or any combination of activities less than the total number included in the group.

Thus, to qualify as a unitary business, the activities involved must constitute a *functionally integrated enterprise which earns its income as a unit or a whole,* thereby justifying apportionment. In accordance with this principle, many of the cases involving dividend income have recognized that apportionability turns on the functional relationship between the activities of the payor and recipient corporations. In addition to *Mobil,* see also *F. W. Woolworth Co.* v. *State of Alaska, Department of Revenue* (Alaska Sup. Ct. Oct. 29, 1981); *Square D Co.* v. *Kentucky Board of Tax Appeals,* 415 S.W.2d 594 (Ky. 1967); *Gulf Oil Corp.* v. *Clayton,* 267 N.C. 15, 147 S.E.2d 522 (1966); *American Bakeries Co.* v. *Johnson,* 259 N.C. 419, 131 S.E.2d 1 (1963); and *Marshall-Wells Co.* v. *Commissioner of Taxation,* 220 Minn. 458, 20 N.W.2d 92 (1945).

The recent *Woolworth* case, *supra,* is squarely in point. There, as here, a parent corporation doing business in the taxing State received dividends from subsidiaries conducting similar businesses in foreign countries. In accordance with *Mobil,* the Alaska Supreme Court expressly held in *Woolworth* that "the business from which the dividends are derived must be part of the unitary business being taxed in order for the dividends to be apportioned." (Slip Op. 2)

In *Square D Co.* v. *Kentucky Board of Tax Appeals, supra,* a parent corporation doing business in Kentucky received dividends from two wholly owned subsidiaries conducting the same type of business in Canada and Mexico. In recognition of the constitutional limitations on state taxation, the court concluded that the Kentucky statute should be construed to prevent the State from including the dividends in the parent's apportionable income. In so holding, the court stated (415 S.W.2d at 602):

> No part of the . . . Canadian or Mexican incomes can be said to have been derived from Kentucky operations unless the apparently independent foreign activities were so integrated and interrelated with those

> in Kentucky that the separate sources cannot be reasonably and separately identified. We do not think this can be said of any of the dividend . . . income here in controversy.

Over the years, a number of other tests for determining the scope of a unitary business have been formulated by the courts.[9] In cases involving the apportionment of dividends, several courts have looked to the "overall size and financial power" which the parent corporation derived from its ownership of the stock of the subsidiaries. *F. W. Woolworth Co.* v. *Director of Div. of Taxation*, 45 N.J. 466, 213 A.2d 1, 14 (1965); *Taxation & Revenue Dept., etc.* v. *F. W. Woolworth*, 95 N.M. 519, 624 P.2d 28 (1981).

In the New Jersey case, the court stated (213 A.2d at 14):

> We know of no United States Supreme Court case holding or even intimating that . . . close functional integration [of the type involved in *Butler Bros.* v. *McColgan, supra*] is a *sine qua non* for a finding of a unitary enterprise. . . .

In *Mobil*, this Court stated (445 U.S. at 440) that dividends may be apportioned "[s]o long as . . . [they] reflect profits derived from a functionally integrated enterprise. . . ." Thus, it is obvious that the New Jersey court's decision—and other prior state court decisions like it—no longer have any vitality.

In its Motion to Dismiss, appellee states (pp. 6-7) that we are misreading *Mobil*, and asserts that attention must be focused on appellant's *own* activities to determine whether appellant's income-producing investments are suf-

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[9] See, *e.g.*, the cases discussed in Keesling and Warren, *op. cit.*, n. 8, *supra*, at 45-52; Hellerstein, *Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business*, 21 Nat.Tax J. 487, 496-501 (1968). See also *Mobil*, 445 U.S. at 439, n. 14 and 443, n. 17.

ficiently related to appellant's other business activities to form part of its Unitary Business. There may be situations, not considered in *Mobil* and not present here, in which it would be appropriate to focus only on the taxpayer's own activities, without regard to the underlying activities of the company paying the dividends.[10] But where, as here, there is no evidence suggesting that the taxpayer's business consists of, or necessarily involves, securities investments, there is no basis under *Mobil* for treating the dividend income as part of the taxpayer's unitary business income unless the underlying business activities generating that income are functionally integrated with the taxpayer's business activities. We shall now show that this type of functional relationship does not exist in the present case.

C. Application of the *Mobil* "Functional Integration" Test to This Case.

To place appellant's constitutional objections in proper perspective, we think it is helpful to focus on the wide range of activities which concededly form part of appellant's Unitary Business. Because it operates a silver mine in Idaho and has an administrative office there, appellant has voluntarily recognized that *all* of its operating income attributable to mining, smelting, refining, and selling nonferrous metals should be included in its Unitary Business income for Idaho apportionment purposes. Appellant's principal product is copper. (J.S.App.A 39a) Since it engages in no copper operations in Idaho (see J.S.App.A 40a), it could plausibly argue that none of its copper receipts or facilities should be reflected in the Idaho apportionment calculation. However, in recognition of the way

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[10] For example, if the taxpayer is a securities dealer or underwriter, it may be constitutionally permissible for a State to treat the taxpayer's dividend and interest income from securities held in inventory as apportionable business income.

in which its various ores and concentrates actually flow through the system and the coordinated way in which its overall metals operations are managed, appellant has treated all of its metals operations as "functionally integrated," with the result that Idaho may take into account the proceeds derived from copper mined in Arizona, smelted in Washington, refined in Maryland, and sold in New York.

We believe that this broad definition of appellant's Unitary Business—a definition which includes *every* phase of appellant's operations from exploration to the sale of the refined metals—fairly compensates Idaho for the benefits appellant receives from the State. Cf. *Exxon Corp.* v. *Wisconsin Dept. of Revenue, supra; Mobil.* What appellant strenuously objects to is Idaho's attempt to reach out and tax appellant's income from investments in independently managed, free-standing companies conducting operations largely unrelated to appellant's domestic metals business.

1. *M.I.M.:* The decision below with respect to the dividends appellant received from M.I.M. is perhaps the clearest example of overextending the State's taxing jurisdiction. The record shows that M.I.M. is a major, publicly held Australian mining corporation with thousands of employees. (J.A. 132a-133a) The State District Court correctly found that M.I.M. operated "entirely independently of" appellant and had only "minimal contact with" appellant. (J.S.App.A 43a)[11] Nor did appellant exercise any control over M.I.M.'s management. During the years involved here,

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[11] During the three years here involved, M.I.M. made sales to appellant which averaged approximately .8 of 1% of M.I.M.'s total sales and M.I.M. paid royalties of approximately $30,000 per year to appellant with respect to a licensed patent. (J.A. 43a, 45a, 47a, 51a) Given the magnitude of M.I.M.'s operations, and the lack of any participation by appellant in M.I.M.'s business at either the operational or management level (J.A. 132a-134a), these transactions are simply not significant. Even the MTC auditor recognized this. (J.A. 83a, 91a)

appellant owned approximately 53% of M.I.M.'s stock, but appellant had *no* representatives on the M.I.M. Board of Directors and the two companies had *no* common directors or officers. (J.A. 34a, 40a, 132a)

In holding that the dividends from M.I.M. constituted apportionable business income, the Idaho Supreme Court stated (J.S.App.A 22a-23a):

> We recognize that M.I.M., for the years in question, seems to have operated independently of ASARCO and did little if any business with ASARCO. Although ASARCO owns a controlling interest in M.I.M., ASARCO did not exercise its right to control the corporation, apparently for political reasons. Nevertheless, ASARCO does own a majority of M.I.M. stock and M.I.M. is engaged in virtually the same business as ASARCO. Given these facts and the statutory presumption we conclude that the trial court erred in concluding that ASARCO's interest in M.I.M. was merely a passive investment unrelated to ASARCO's mining and smelting business.

Thus, the decision below would permit the taxation of dividend income received from out-of-state sources if the resident corporation receiving the dividend owns a "controlling" stock interest in the nonresident payor corporation and both corporations are in "virtually the same business." Taxation would be permitted even though (1) the recipient corporation admittedly "did not exercise its right to control" the payor corporation; (2) the payor corporation "operated independently of" the recipient corporation; and (3) the two corporations "did little if any business" with each other. Such a result is clearly contrary to *Mobil*.

The controlling factors under *Mobil* are the absence of any participation by appellant in the management or operation of M.I.M., and the absence of any significant business dealings between them. Under these circumstances, it is clear that the requisite functional integration is missing.

M.I.M. ran its *own* business; appellant was simply a passive investor. There is no reason why Idaho should be permitted to tax *any* portion of the profits generated by a foreign mining operation having no functional or other relationship to any business being conducted in Idaho.

2. *General Cable and Revere:* Neither of these corporations was even in the same business as appellant. Both were engaged in fabricating metal products. General Cable manufactured and sold cables; Revere manufactured and sold copper wares. (J.A. 50a) By contrast, appellant's Unitary Business consisted of the mining, smelting, refining, and selling of nonferrous metals, including copper, in bulk form. Appellant produced some metal alloys, but it did not manufacture *any* copper products or other metal products. (J.S.App.A 39a-40a; J.A. 83a-84a)

General Cable and Revere were customers of appellant. However, they also purchased copper from other suppliers,[12] and their business dealings with appellant were conducted on a strictly arm's length basis. Indeed, under a consent decree signed in connection with an antitrust proceeding, appellant was expressly prohibited from selling copper to them at prices lower than those charged to their competitors. (J.S.App.A 9a; J.A. 96a) The decree also required appellant to dispose of all of its General Cable stock. Following this disposition in 1970, General Cable continued as a customer of appellant on the same basis as it had previously. (J.A. 137a) In addition, both General Cable and Revere were publicly held and independently managed. Appellant only owned approximately 34% of their stock, and, under the consent decree, appellant was prohibited from voting this stock or maintaining any common officers or directors. (J.S.App.A 8a-9a; J.A. 135a) Thus, appellant had absolutely no voice in the management

[12] In addition, appellant sold its output to other customers. The purchases by General Cable and Revere accounted, in round numbers, for only 6% and 3%, respectively, of appellant's total sales during the period in issue. (J.A. 27a)

of either General Cable or Revere during the years in question. (J.A. 35a, 40a)

There is nothing in these circumstances to warrant treating the manufacturing activities of General Cable or Revere as part of appellant's mining, smelting, and refining business. The sale of a product by one independently managed corporation to another on an arm's length basis is the most common sort of transaction. If both corporations could be treated as being engaged in the same unitary business by reason of such sales, virtually the entire United States economy would constitute a single unitary business. Obviously more is required.

As discussed above, the issue here is to determine appellant's Idaho taxable income earned from its Idaho activities. That is all Idaho can tax. Any benefits which inure to Idaho as a result of appellant's sales to General Cable and Revere are sufficiently reflected by the inclusion of the proceeds from those sales in the apportionable income of appellant's separate Unitary Business. Because appellant conducted no manufacturing operations of its own, either in Idaho or elsewhere, there is no reason to take the further step of redefining its Unitary Business to include General Cable's and Revere's independently managed manufacturing operations and to apportion the income from those operations as well.[13]

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[13] Nor should it make any difference that General Cable and Revere both used appellant's stock transfer department or that Revere used a patent of appellant's for a fee. (J.A. 136a) Those intercompany transactions are simply too inconsequential to make any difference. They are comparable to the situation in *Commonwealth* v. *Advance-Wilson Industries, Inc.*, 456 Pa. 200, 317 A.2d 642 (1974), where a ceramic tile business and electrolyzing business, which were run as separate divisions of a single company, were held to be separate businesses. It did not matter that the home office performed certain administrative and other functions for both divisions.

3. *Mexicana:* Appellant owned only 49% of Mexicana's stock and accordingly did not exercise control over Mexicana. The name "ASARCO Mexicana" stems from a prior period when appellant owned 100% of the stock of Mexicana's predecessor. By the years in issue, however, such ownership was effectively prohibited by Mexican law, and Mexicana operated independently of appellant. There were no common officers of the two companies. (J.A. 128a-130a)

Moreover, although appellant and Mexicana were engaged in the same type of business, their businesses were not functionally integrated. The business relationship between them was limited to some services which appellant provided for a fee and some spot purchases of copper by appellant. (J.S.App.A 9a-10a; J.A. 130a-131a) As discussed above, limited intercompany transactions of this sort are simply too minor to make Mexicana's activities part of appellant's Unitary Business.

4. *Southern Peru:* Southern Peru mines and smelts copper in Peru, and sells the resulting "blister copper" to appellant, three other mining companies, and unrelated European customers. Although appellant owns 51.5% of Southern Peru's stock, the company's by-laws provide that appellant cannot exercise control through the directors it elects. Southern Peru has its own staff, although appellant furnishes it with certain technical services for a fee. (J.S. App.A 7a; J.A. 121a-124a)

While appellant purchases roughly 35% of Southern Peru's blister copper production pursuant to a long-term supply contract (J.S.App.A 7a), this does not mean that Southern Peru's business must be viewed as part of appellant's Unitary Business. There may be cases, as suggested by the MTC at p. 15 of its *amicus* brief in support of appellee's Motion to Dismiss, where a stock investment in an important supplier or customer can appropriately be treated as a "business" asset of the taxpayer so that dividends received with respect to that stock are part of the taxpayer's unitary business income. But in deciding

whether this treatment is proper, the test should be no different from that applied with respect to any other stock investment. In each instance, the critical question is whether the activities of the taxpayer and the other corporation are so closely interrelated that the income attributable to the taxpayer's activities in the taxing jurisdiction cannot be fairly determined without taking into account income from the activities performed by the other corporation outside the taxing jurisdiction.

Judged by that standard, the dividends which appellant received from Southern Peru do not belong in the Idaho tax calculation. Southern Peru was not a captive mine which shipped all or substantially all of its output to appellant under circumstances making it difficult to separately account for the two companies' respective incomes. Cf. *Exxon Corp.* v. *Wisconsin Dept. of Revenue, supra,* 447 U.S. at 224-225, 226, involving "a highly integrated business which benefits from an umbrella of centralized management and controlled interaction."[14] On the contrary, it was perfectly possible to determine Southern Peru's separate income in an accurate, reliable fashion because the sales made to appellant were made on the same arm's length basis and at the same average prices which appellant paid to other *completely unrelated* suppliers who sold copper to appellant under

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[14] Moreover, there was undisputed testimony establishing that the supply contract was not "necessary" to appellant, and could probably be "replaced . . . [w]ithin a short time" with copper from other sources. (J.A. 128a) There was also undisputed testimony to the effect that loss of appellant's stock investment in Southern Peru would not result in loss of the supply contract. (*Ibid.*) Thus, while Southern Peru was an "important" source of supply (*ibid.*), the supply contract was by no means a necessary or integral part of appellant's Unitary Business. More fundamentally, the sales by Southern Peru to appellant did not create a situation where Idaho would be "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Underwood Typewriter Co.* v. *Chamberlain, supra,* 254 U.S. at 121.

long-term output contracts. (J.A. 125a-127a) Where, as here, there is uncontradicted evidence establishing that the taxpayer has dealt with an affiliated supplier on the same arm's length basis as it has dealt with "many" other suppliers "in which [it] has no interest" (J.A. 126a, 127a), the profits made by the affiliated supplier are no more a part of the taxpayer's unitary business income than the profits made by the unrelated suppliers. Consequently, dividends paid out of the affiliated supplier's profits are not apportionable.

D. Appellant's Interest and Capital Gains Are Not Apportionable Income.

Mobil involved only dividend income; the present case also involves interest income and capital gains attributable to appellant's investments in the dividend-paying corporations.

There are many cases in which state courts have considered whether a resident corporation's interest income or capital gains from intangibles are sufficiently related to the corporation's activities within the taxing State to justify apportionment under local law.[15] Interest from short-term investments of operating income has generally been apportioned.[16] Interest income derived from loans regularly made to affiliated corporations engaged in a related business has also been held apportionable.[17] On the other hand, interest

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[15] See, *e.g.*, *Qualls* v. *Montgomery Ward & Co., Inc.*, 266 Ark. 207, 585 S.W.2d 18 (1979); *Atlantic Richfield Co.* v. *State*, 191 Colo. 413, 601 P.2d 628 (1979); *Champion International Corp.* v. *Bureau of Revenue*, 88 N.M. 411, 540 P.2d 1300 (Ct.App. 1975); *People ex rel. Alpha Portland Cement Co.* v. *Knapp*, 230 N.Y. 48, 129 N.E. 202 (1920).

[16] *Great Lakes Pipe Line Co.* v. *Commissioner of Taxation*, 272 Minn. 403, 138 N.W.2d 612 (1965); *Montgomery Ward & Co. Inc.* v. *Commr. of Taxation*, 276 Minn. 479, 151 N.W.2d 294 (1967); *Champion International Corp.* v. *Bureau of Revenue, supra.*

[17] *Qualls* v. *Montgomery Ward & Co., Inc., supra.*

from long-term securities has been held nonapportionable.[18] Cases involving capital gains from the sale of intangible assets used in the business have been somewhat inconsistent. Gain from the sale of stock investments has been treated as apportionable income in some cases,[19] but not in others.[20] Gain from the sale of leases has also been treated as apportionable in some cases,[21] but not in others.[22]

In the present case, appellant has not contested Idaho's right to treat interest income from temporary deposits of appellant's working capital funds as apportionable business income derived in the ordinary course of appellant's Unitary Business activities. However, appellant firmly believes that Idaho has no constitutional right to tax any portion of the interest income or capital gains which appellant realized from its long-term investments in M.I.M., General Cable, Revere, and Mexicana.[23]

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[18] *Sperry & Hutchinson* v. *Dept. of Rev.*, 270 Ore. 329, 527 P.2d 729 (1974).

[19] See, *e.g.*, *W. R. Grace & Co.* v. *Commissioner of Rev.*, 378 Mass 577, 393 N.E. 2d 330 (1979); *Commonwealth* v. *Emhart Corporation*, 443 Pa. 397, 278 A.2d 916, *cert. denied*, 404 U.S. 981 (1971).

[20] See, *e.g.*, *Commonwealth* v. *ACF Industries*, 441 Pa. 129, 271 A.2d 273 (1970), where the gain was not apportioned because the activities of the company whose stock was sold were unrelated to the activities of the seller in the taxing State.

[21] See, *e.g.*, *Tipperary Corp.* v. *New Mexico Bur. of Rev.*, 93 N.M. 22, 595 P.2d 1212 (1979).

[22] See, *e.g.*, *Western Natural Gas Co.* v. *McDonald*, 202 Kan. 98, 446 P.2d 781 (1968).

[23] The interest income in dispute consists of interest received in connection with the 1970 disposition of General Cable stock, interest on Revere convertible debentures, and interest on a note received in connection with a prior sale of Mexicana stock. The capital gains in issue consist of gains realized by appellant on the sale of part of its long-term stock investment in M.I.M. and the disposition of all of its stock investment in General Cable. (See J.A. 51a, 53a; Juris. Statement 4-5)

For constitutional purposes, the interest income and capital gains from appellant's investments in the foregoing companies should be excluded from appellant's apportionable business income for the same reasons that appellant's dividend income from those companies is excludable. The capital gains, interest, and dividends all stand on the same tax footing because they all stem from long-term capital investments in the stock or securities of out-of-state companies whose businesses are functionally distinct from appellant's Unitary Business. Because *none* of the investment income was generated directly or indirectly by any activities even remotely connected with appellant's Idaho activities, there is no reason why Idaho should be permitted to tax *any* portion of that income.

II. ALTERNATIVELY, EVEN IF SOME PORTION OF THE DIVIDENDS, INTEREST, AND CAPITAL GAINS MAY CONSTITUTIONALLY BE INCLUDED IN APPELLANT'S APPORTIONABLE BUSINESS INCOME, BOTH THE DUE PROCESS CLAUSE AND THE FOREIGN COMMERCE CLAUSE WILL BE VIOLATED UNLESS A CORRELATIVE ADJUSTMENT IS MADE TO IDAHO'S APPORTIONMENT FACTORS.

A. The Due Process Clause.

The only Due Process Clause issue considered in *Mobil* was whether Mobil's dividend income from subsidiaries and affiliates could be included in Mobil's apportionable income. Because Mobil did not present the question, the Court expressly refrained from deciding whether the inclusion of such dividends in apportionable income would necessitate some correlative adjustment to Vermont's apportionment factors. See 445 U.S. at 434, 441, n. 15, and 449.

We have previously contended that, under the Due Process Clause, the dividends, interest, and capital gains in issue may not be included in appellant's apportionable business income. If, however, the Court holds that any of

those items may be included in appellant's apportionable income, correlative adjustments to Idaho's apportionment factors will be required to satisfy the requirements of the Due Process Clause. Unless the apportionment factors are adjusted, the method used by Idaho will be "inherently arbitrary." See *Underwood Typewriter Co.* v. *Chamberlain, supra,* 254 U.S. at 121; *Bass, Ratcliff & Gretton* v. *State Tax Commission, supra,* 266 U.S. at 282-283.

Although the Court did not reach the issue in *Mobil,* Mr. Justice Stevens stated in his dissent (445 U.S. at 461):

> Unless the sales, payroll and property values connected with the production of income by the [dividend] payor corporations are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will *inevitably* cause Mobil's Vermont income to be overstated. [Footnote deleted; emphasis supplied.]

The reason for Mr. Justice Stevens' conclusion is clear. Idaho, as a nondomiciliary State, can tax appellant only on that portion of its income which is attributable to appellant's activities in Idaho. In determining that amount, it should make no difference whether appellant's Unitary Business (whose income is being apportioned for this purpose) is conducted through divisions or separately incorporated subsidiaries. As this Court stated in *Mobil* (445 U.S. at 440-441):

> Had appellant chosen to operate its foreign subsidiaries as separate divisions of a legally as well as a functionally integrated enterprise, there is little doubt that the income derived from those divisions would meet due process requirements for apportionability. Cf. *General Motors Corp.* v. *Washington,* 377 U.S. 436, 441 (1964). *Transforming the same income into dividends from legally separate entities works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives.* [Footnote deleted; emphasis supplied.]

Thus, if the total amount of apportionable income in the parent-subsidiary case remains the same as it is where the parent operates through divisions, it follows that the share or percentage of that income properly apportionable to the taxing State also ought to remain the same. After all, the value of the activities carried on in the taxing State is not affected by the taxpayer's corporate structure any more than is the amount of the taxpayer's apportionable income.

However, the results of operating a unitary business through a subsidiary will *not* be the same as the results of operating through a division unless the apportionment formula is appropriately adjusted when dividends paid by the subsidiary are included in the taxpayer's apportionable income. This can be demonstrated by assuming that the taxpayer conducts a unitary business through two divisions (Division A, which operates both inside and outside Idaho, and Division B, which operates entirely outside Idaho). Assume the following figures:

	Division A		Division B	
	All Locations	Idaho Situs	All Locations	Idaho Situs
Property	$200,000	$20,000	$100,000	-0-
Payroll	300,000	30,000	150,000	-0-
Sales	400,000	40,000	200,000	-0-
Business Income	50,000		10,000	

On these facts, the income apportioned to Idaho will be $4,000, computed as follows:

Total Business Income = $50,000 + $10,000 = $60,000

Idaho Factors:

$$\left[\frac{\text{Property } 20{,}000}{300{,}000} + \frac{\text{Payroll } 30{,}000}{450{,}000} + \frac{\text{Sales } 40{,}000}{600{,}000}\right] \div 3 = \frac{1}{15}$$

$$\text{Idaho Taxable Income} = \$60{,}000 \times \frac{1}{15} = \$4{,}000$$

Now assume that the taxpayer retains the Division A business, but places the Division B business in a new wholly owned subsidiary. If all of the subsidiary's income is distributed as a dividend to the parent and included in apportionable business income, the results will be markedly different if there is no adjustment in the parent's apportionment factors. Under these circumstances, the income apportioned to Idaho will be increased by 50% to $6,000, computed as follows:

Parent's Business Income = $50,000 + $10,000 = $60,000

Parent's Idaho Factors:

$$\left[\underset{\text{Property}}{\frac{20{,}000}{200{,}000}} + \underset{\text{Payroll}}{\frac{30{,}000}{300{,}000}} + \underset{\text{Sales}}{\frac{40{,}000}{400{,}000}}\right] \div 3 = \frac{1}{10}$$

$$\text{Idaho Taxable Income} = \$60{,}000 \times \frac{1}{10} = \$6{,}000$$

The Idaho Supreme Court held that inclusion of the dividends in appellant's apportionable income did not require any adjustments in the apportionment factors. This conclusion stemmed from a misapprehension of the rationale for including the dividends in appellant's apportionable business income. It is apparent from the Idaho Supreme Court's opinion that the dividends were perceived to be apportionable income because of appellant's *own* activities (namely, the ownership of the stocks involved), rather than the activities of the dividend-paying corporations. See J.S.App.A 29a and the Idaho Supreme Court's reliance on *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 133 Vt. 93, 328 A.2d 402 (1974) and *F. W. Woolworth Co.* v. *Director of Div. of Taxation, supra.* Appellee has also adopted this approach by arguing in its Motion to Dismiss or Affirm (pp. 6-7, 16) that the dividend income represents appellant's own income from intangibles (not the income of the dividend-paying corporations) and, as such, can be taxed by Idaho.

It is now clear, however, from this Court's opinion in *Mobil*, that the inclusion of dividends in apportionable business income in a case like this depends on the underlying activities of the dividend-paying corporations—activities clearly carried on outside Idaho—and not on appellant's own activities. Thus, if the dividends are to be included in the apportionable base (as part of the procedure for determining what may be constitutionally taxed in Idaho), the apportionment factors must be correlatively reduced to reflect the property, payroll, and sales of the corporations whose businesses generated the dividends. Only in that way will the result be the same as it would have been if the businesses conducted by those corporations had been conducted directly in divisions of appellant. As the above example demonstrates, failure to reduce the apportionment fractions results in a *gross* overstatement of the portion of the unitary business income which is properly attributable to the taxing State and *penalizes* the taxpayer for operating through a subsidiary rather than a division.

Indeed, as recently conceded by the Executive Director of the MTC, failure to adjust the apportionment fractions in a case like the present one "produces a still higher tax result for the State" than combined reporting does.[24] This Court recently noted probable jurisdiction in a case challenging the constitutionality of combined reporting as applied to foreign subsidiaries and affiliates.[25] While we agree with the position taken by the appellant in that case, it is not necessary to reach the issues raised there to sustain

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[24] See Corrigan, *Mobil-izing Interstate Taxation*, Tax Notes, Vol. XIII, No. 15, Oct. 12, 1981, p. 808 (comparing Cases B and E to Case C, which is comparable to the present case).

[25] *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al., prob. juris. noted*, —— U.S. ——, No. 81-349. See also *Container Corporation of America* v. *Franchise Tax Board*, 117 Cal. App. 3d 988, 173 Cal. Rptr. 121 (1981), appeal docketed, No. 81-523.

appellant's position here. The MTC's admission that the decision below produces a "still higher tax result for the State" than does combined reporting is a direct acknowledgment that inclusion of dividends in the recipient's apportionable income without an adjustment in the apportionment factors results in a conceptually indefensible overstatement of the income attributable to the taxing State. As demonstrated above, the State is certainly attempting to collect a "higher tax" from appellant than it could ever hope to collect if appellant's subsidiaries were unincorporated divisions.[26] Penalizing appellant in this fashion is patently arbitrary and an unconstitutional violation of due process. *Norfolk & Western Ry. Co.* v. *Missouri State Tax Commission*, 390 U.S. 317 (1968); *Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931); *Underwood Typewriter Co.* v. *Chamberlain, supra; People ex rel. Alpha Portland Cement Co.* v. *Knaop*, 230 N.Y. 48, 129 N.E. 202 (1920). Appellee has ignored this Court's holding in *Mobil* (445 U.S. at 441) that trans-

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[26] For example, for 1969, appellant's reported apportionable business income of $22,364,079 (J.A. 109a) was increased on audit by approximately $59 million as a result of the inclusion of the dividends, interest, and capital gains in dispute here. (See App.B, *infra*, 5a) The dividends alone accounted for approximately $55 million. (*Ibid.*) However, *none* of the property, payroll, or sales of the dividend-paying subsidiaries and affiliates were taken into account by the MTC auditor. The only token gesture made by the auditor was to increase the denominator of the sales fraction by the dividends and interest. (J.A. 73a) As a result, the apportionment factor was reduced by only .06709 of 1% from 2.59955% to 2.53246%. (See App.B, *infra*, 6a) Comparable adjustments to apportionable business income and the apportionment factor were made in 1968 and 1970. These *de minimis* adjustments to the apportionment factor in each year were plainly inadequate to reflect the underlying property, payroll, and sales which (1) produced the additional income, and (2) would have been taken into account had the businesses been run as unitary divisions of appellant rather than being run by separate subsidiaries and affiliates.

forming divisional profits of a unitary business into dividends "works no change in the underlying economic realities of a unitary business, and accordingly it ought not to affect the apportionability of income the parent receives."[27]

The issue is not, as appellee would have it, whether dividends *per se* are the income of the recipient or are paid out of the income of the payor. (See Motion to Dismiss, p. 16.) The real issue is whether the apportionment formula fairly employs, on a consistently applied basis, factors which reflect " 'the relative contribution of the activities in the various states to the production of the total unitary income.' " *Butler Bros.* v. *McColgan, supra,* 315 U.S. at 509. Under formulary apportionment, the total income of the unitary business must be ratably divided (on the basis of the apportionment factors employed) between

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[27] Appellee's attempt to hide behind corporate barriers is made clear by the example in its Motion to Dismiss (pp. 15-16) in which a taxpayer described in the motion as doing business only in Idaho and Oregon receives a dividend from a corporation which "confines all of its business activities to the State of Wyoming." Appellee asserts that it is incorrect for the taxpayer-recipient to take into account the Wyoming property, payroll, and sales of the dividend-paying corporation because the taxpayer "conducts no business" in Wyoming and "cannot be said to have earned taxable income in Wyoming." This conclusion is manifestly inconsistent with the premise on which appellee's example is based. If the dividend is properly treated as part of the taxpayer's unitary business income, which it must be before it can be apportioned under *Mobil*, then it is manifest that a portion of the income of the unitary business has been earned in Wyoming. After all, the example presupposes that the company paying the dividend "confines all of its business activities" to Wyoming. Under these circumstances, the dividend paid out of the Wyoming income is not subject to tax as such by a nondomiciliary State in which the recipient also does business. The nondomiciliary State may only tax income which is attributable to activities in that State. Recognition of the Wyoming property, payroll, and sales in the Idaho and Oregon apportionment factors is an appropriate way of achieving that result.

the taxing State and all other jurisdictions in which the unitary business is conducted, so that the taxing State receives the same "rate of return" as is earned by the entire business collectively.[28] Thus, where the traditional three-factor apportionment formula is properly employed, the taxing State should receive the same amount of income for every dollar of property, payroll, and sales in the State as the entire unitary business earns for every dollar of total property, payroll, and sales in all locations. This concept *cannot possibly work*, however, if a State which uses the three-factor formula overloads its own "rate of return," as Idaho has done here, by giving full weight to property, payroll, and sales in the State, but only token weight to sales outside the State, and no weight *at all* to property and payroll outside the State. By ignoring out-of-state property and activities, Idaho has unfairly increased the weight given to property and activities within the State. By so doing, it seeks to increase its "rate of return" (*i.e.*, the income it earns for every dollar of local property, payroll, and sales) to a rate *higher* than the average rate applicable to the unitary business as a whole. This is so alien to the whole concept of "unitary" apportionment that it is a *per se* violation of the Due Process Clause.

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[28] The basic apportionment formula, using a single property, payroll, and sales ("PPS") factor for simplicity, is:

$$\text{unitary income} \times \frac{\text{state PPS}}{\text{total PPS}} = \text{state income}$$

Mathematically, this is equivalent to:

$$\frac{\text{state PPS}}{\text{total PPS}} = \frac{\text{state income}}{\text{unitary income}}$$

The "rate of return" everywhere should be constant because the foregoing equation can be rewritten:

$$\frac{\text{state income}}{\text{state PPS}} = \frac{\text{unitary income}}{\text{total PPS}}$$

This view of the conceptual relationship between apportionable business income and the apportionment factors is hardly new or novel. In addition to Mr. Justice Stevens' recognition of this relationship in his dissent in *Mobil*, see also *People ex rel. Alpha Portland Cement Co.* v. *Knapp*, *supra*, and *Household Finance Corp.* v. *State Tax Commission*, 212 Md. 80, 128 A.2d 640, 649 (1957). Cf. *F. W. Woolworth Co.* v. *Commissioner of Taxes*, 130 Vt. 544, 298 A.2d 839 (1972). In the *Alpha Portland Cement* case, as here, investment income was included in apportionable income without adjusting the apportionment factor to reflect the out-of-state assets which generated the income. The court, in an opinion by Judge Cardozo, invalidated the statutory scheme, stating (129 N.E. at 204, 206):

> The interest enters into the income on which the tax has been computed; the principal has been excluded in the allocation of the assets.
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> Dividends from other shares, those of the Anvil Stone Company, are included in the income; the shares themselves do not enter into the terms of the proportion.
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> [T]he statute prescribes a rule of allocation which, as applied to foreign corporations holding bonds and shares in other states, involves an artificial and arbitrary augmentation of the value of the local privilege. It measures the value of the franchise, here and elsewhere, by income from all sources, and excludes some of the same sources when the value is apportioned. *To take from assets elsewhere is equivalent to adding to assets here.*
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> [A] method of apportionment which purposely ignores realities, which compels an assessor to look to some of the assets only, and close his eyes to all the others, is arbitrary and unreasonable in its increase of the local burden. [Emphasis supplied.]

Similarly, Idaho should not be permitted to add to the income-producing value of the property, payroll, and sales

in Idaho by ignoring a substantial portion of the income-producing property, payroll, and sales outside the State. If some portion of the dividends, capital gains, or interest in issue here is to be included in appellant's apportionable business income, due process requires that the apportionment factors be modified in a way which will meaningfully and fairly reflect the out-of-state property, payroll, and sales which generated that income.

With respect to dividends, we believe, as proposed below, that this can ordinarily best be done by increasing the denominators of the property, payroll, and sales fractions by an appropriate percentage of the property, payroll, and sales of the corporations paying the dividends. The appropriate percentage, in each case, could be determined by comparing the dividends received by appellant from a particular corporation with that corporation's earnings for that year. For example, if appellant owned 50% of a corporation's stock and the corporation paid out 30% of its earnings for the year as dividends, 15% (*i.e.*, 30% of 50%) of the corporation's property, payroll, and sales for that year would be included in the denominators of appellant's apportionment fractions for that year.[29]

Appellee objects (Motion to Dismiss, p. 14) to the sufficiency of the evidence in this case, asserting that it fails to satisfy the "clear and cogent" standard of *Butler Bros.* v. *McColgan, supra*, 315 U.S. at 507, which applies when

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[29] There are a number of approaches which might be taken to modify the apportionment factors if interest or capital gains are included in apportionable business income. Consequently, if it becomes necessary to modify the apportionment factors in this case, we suggest that this be done, in the first instance, by the State District Court on remand, in the light of the specific facts bearing on the particular dividends, interest, or gains in issue. Of course, appellant reserves the right to challenge the constitutionality of any modified apportionment formula adopted by the MTC or State District Court if that formula, as applied to appellant, results in a denial of due process as defined by this Court's decisions.

a taxpayer attempts to show that the taxing State's apportionment formula results in the taxation of "extraterritorial values." However, the dramatic eight-fold increase in appellant's Idaho taxable income for the years 1969-1970 (see p. 6, *supra*) more than satisfies any evidentiary burden. Moreover, as this Court pointed out in *Underwood Typewriter Co.* v. *Chamberlain, supra,* 254 U.S. at 121, an apportionment formula can be invalidated by showing that it is "inherently arbitrary." In view of the demonstrated conceptual relationship between the apportionment base and the apportionment factors, Idaho's failure to adjust the apportionment factors will "inevitably" produce an arbitrary result if the dividends or other comparable income items are included in the apportionable income base. See *Mobil,* 445 U.S. at 461 (dissenting opinion).

B. The Foreign Commerce Clause.

Mobil also involved the application of the Commerce Clause, but the decision there is not dispositive of the Foreign Commerce Clause issue presented here. In *Mobil,* the taxpayer argued that Vermont's tax imposed a burden on interstate and foreign commerce by subjecting Mobil's dividend income to a substantial risk of multiple state taxation. Mobil premised that multiple taxation argument on the assumption that all of its dividend income was fully taxable in the State of commercial domicile (New York, in its case) and, therefore, any apportionment to Vermont unavoidably subjected Mobil to the risk of multiple state taxation.

This Court rejected Mobil's argument, both with respect to an alleged burden on interstate commerce and with respect to foreign commerce. With respect to interstate commerce, the Court stated (445 U.S. at 445-446):

> Although we do not now presume to pass on the constitutionality of a hypothetical New York tax, we may assume, for present purposes, that the State of com-

> mercial domicile has the authority to lay some tax on appellant's dividend income as well as on the value of its stock. But there is no reason in theory why that power should be exclusive when the dividends reflect income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to benefits and privileges conferred by several States. These are the circumstances in which apportionment is ordinarily the accepted method. Since Vermont seeks to tax income, not ownership, we hold that its interest in taxing a proportionate share of appellant's dividend income is not overridden by any interest of the State of commercial domicile.

Then, with respect to Mobil's foreign commerce argument, this Court added (445 U.S. at 446-447):

> . . . Mobil suggests that dividends from foreign sources must be allocated to the State of commercial domicile, even if dividends from subsidiaries and affiliates operating domestically are not. By accepting the power of the State of commercial domicile to tax foreign-source dividend income, appellant eschews the broad proposition that foreign-source dividends are immune from state taxation. It presses the narrower contention that, because of the risk of multiple taxation abroad, allocation of foreign-source income to a single situs is required at home.
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> By admitting the power of the State of commercial domicile to tax foreign-source dividends *in full*, Mobil necessarily forgoes any contention that local duplication of foreign taxes is proscribed. Thus, the only inquiry of constitutional dimension is the familiar question whether taxation by apportionment at home produces significantly greater tax burdens than taxation by allocation. Once appellant's argument is placed in this perspective, the presence or absence of taxation abroad diminishes in importance.

Appellant now asserts the Foreign Commerce Clause argument which Mobil refrained from making—namely, that *any* "local duplication of foreign taxes is proscribed."

As a general rule, *interstate* commerce is not exempt from state taxation provided the state tax in issue is applied to an activity having a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State. *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977); *Washington Rev. Dept.* v. *Stevedoring Assn.*, 435 U.S. 734, 750 (1978). But when a State seeks to tax *foreign* commerce, two additional questions must be considered: "[f]irst, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'" *Japan Line, Ltd.*, v. *County of Los Angeles*, 441 U.S. 434, 451 (1979) (hereinafter "*Japan Line*"). "If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." *Ibid.* Idaho's tax contravenes both precepts.

1. *The Substantial Risk of Double Taxation:* There is worldwide recognition of the principle that the source nation (*i.e.*, the nation where income originates) has the primary right to tax the gross amount of dividends, interest, royalties, and other similar items of income paid by a resident of the source nation to a nonresident.[30] In accordance with that "custom of nations" (*Japan Line*, 441 U.S. at 447, 454), Australia and Mexico both impose their income tax on the full amount of dividends and interest paid by resident companies to nonresidents.[31] Accordingly, appellant was subject to a 15% Australian withholding tax

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[30] See the discussion in nn. 37 and 38, *infra*.

[31] See Secs. 128A, 128B, and 221YL of the Australian Income Tax Assessment Act 1936, as amended by Act No. 85, Acts of the Parliament of the Commonwealth of Australia (1967); and Articles 60 V, 61, 73 I and 74 of the Mexican Income Tax Law repro-

and a 20% Mexican withholding tax on the full amount of the dividends it received from M.I.M. and Mexicana, respectively.[32] Appellant was also subject to a 10% Mexican withholding tax on the full amount of the interest it received on the note issued to it in connection with its prior sale of Mexicana stock.[33] During the years in issue, appellant's dividends from M.I.M. amounted to over $63 million, its dividends from Mexicana amounted to over $5 million, and its interest on the Mexican note amounted to more than $1 million. (J.A. 52a-53a) Its foreign tax liability on these items therefore amounted to over $10.5 million. Consequently, any taxation by Idaho of this foreign source income "creates more than the *risk* of multiple taxation; it produces multiple taxation in fact." *Japan Line*, 441 U.S. at 452.

In *Japan Line*, the question was whether local governmental units in California could impose property taxes on cargo containers that were subject to tax in Japan. Because Japan taxed the full value of the containers, this Court held that *any* additional state tax, regardless of how the tax was apportioned, would inevitably produce double taxation in contravention of the Foreign Commerce Clause.

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duced in App. A, *infra*. These laws clearly provide that the foreign withholding taxes are imposed on the nonresident recipient of the dividends or interest payment. Although the tax is remitted to the foreign government by the foreign payor of the dividend or interest, the payor is simply acting as a withholding agent for the recipient. Thus, it is clear that the taxpayer subject to foreign tax on the dividends and interest in question here was appellant—not M.I.M. or Mexicana.

[32] *Ibid.* By reason of Article VII of the Income Tax Convention between the United States and Australia, May 14, 1953, 4 U.S.T. 2274, T.I.A.S. No. 2880, the Australian statutory withholding tax rate was reduced to 15%.

[33] See Articles 60 I, 61 and 66 of the Mexican Income Tax Law reproduced in App. A, *infra*.

We recognize that a different situation may be presented in the case of income taxes. The theory of apportionment, as applied in an income tax context, is that the taxing State is not taxing any out-of-state income as such, but is simply using the out-of-state income, and the out-of-state property, payroll, and sales factors, as a means of more accurately calculating the portion of the total income which is fairly attributable to the activities in the taxing State. Thus, if foreign-source income items which have been taxed abroad are included in the apportionable income base, it is conceivable that multiple income taxation by the State could be avoided by a correlative decrease in the apportionment factors to reflect the foreign property, payroll, and sales associated with that income.[34] We have previously argued that such an adjustment to the apportionment factors is required by the Due Process Clause. However, if the Court

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[34] Since such an adjustment to the apportionment factors would decrease the percentage of the other apportionable income that would otherwise be taxed by the nondomiciliary State, the adjustment could theoretically offset the effect of imposing a second tax on a portion of the foreign-source income.

There are, however, powerful arguments which can be made to support the conclusion that unitary apportionment of foreign-source income in this fashion is not constitutionally acceptable in practice, even if theoretically appropriate apportionment factors are used. See the Jurisdictional Statements filed in *Chicago Bridge & Iron Company* v. *Caterpillar Tractor Co., Illinois Department of Revenue et al., supra,* and *Container Corporation of America* v. *Franchise Tax Board, supra.* We need not now reach that issue in this case, since it is clear that Idaho has made no meaningful adjustment to its regular apportionment factors, with the result that a double tax is being asserted. If this case is remanded for the purpose of permitting the State to modify the apportionment factors, appellant reserves the right to challenge the constitutionality of the modified apportionment formula if, in light of the facts and this Court's decisions, the formula as applied to appellant still results in the effective imposition of a state tax on foreign-source income which has already been taxed abroad.

holds that the Due Process Clause does not require Idaho to make a correlative adjustment to the apportionment factors, Idaho would then be taxing a portion of the foreign dividends and interest *in addition to* its full share of the other apportionable business income. Under these circumstances, it *unavoidably* follows that the dividends and interest would be subject to multiple taxation—full taxation by the source nation and partial taxation by Idaho. Such a result cannot be squared with *Japan Line*.

2. *Federal Government Policy:* The remaining consideration that must be taken into account under *Japan Line* is whether the asserted state tax may "impair federal uniformity" by preventing the Federal Government from " 'speaking with one voice when regulating commercial relations with foreign governments.' " *Japan Line*, 441 U.S. at 448, 451. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees* v. *United States*, 289 U.S. 48, 59 (1933).

Since the enactment of sections 222 and 238 of the Revenue Act of 1918, ch. 18, 40 Stat. 1057, the revenue laws of the United States have been premised on the principle that the jurisdiction where income is generated has the primary right to tax that income, with the result that United States taxpayers should be allowed to reduce their regular federal tax liability by the amount of foreign income tax paid on their foreign-source income.[35] Surrey, *Current Issues in the*

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[35] The foreign tax credit provisions were originally adopted in the Revenue Act of 1918 in order to relieve a "very severe burden" imposed as the result of multiple taxation. H.R. Rep. No. 767, 65th Cong., 2d Sess. (1918) (1939-1 C.B. (Pt. 2) 86, 93). The substance of those provisions of the 1918 Revenue Act is now contained in sections 901 and 902 of the Internal Revenue Code. A credit mechanism is needed to avoid double taxation because a

Taxation of Corporate Foreign Investment, 56 Colum. L. Rev. 815, 817 (1956); E. Owens, *The Foreign Tax Credit* (1961), pp. 2-3, 590-591. The United States has also sought to reduce the risk of double taxation of dividends through tax treaties which assure that the recipient's country will allow a credit or offset for taxes paid to the source country.[36] The position taken by the United States in its treaties is in accordance with model international tax conventions which have recognized the primary right of the source nation to impose a tax on corporate dividends, with the nation where the shareholder resides having a concomitant responsibility to reduce its regular tax on that dividend income by an equivalent amount. See Article 10, Article 23A, and Article 23B of the Draft Double Taxation Convention on Income and Capital (1963) adopted by the Organization for Economic Co-Operation and Development (the "OECD").[37]

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domestic corporation or citizen of the United States is subject to United States tax on worldwide income. When the income is from sources outside the United States and is taxed in the country where it originates, the United States taxpayer may take a credit for the foreign taxes paid. The credit generally operates to reduce the effective overall tax rate to the foreign or the federal rate, whichever is higher. Double taxation is eliminated because, in effect, only one tax is paid at the higher of the two rates. E. Owens, *The Foreign Tax Credit* (1961), pp. 3-6.

[36] Provisions to this effect are included in 27 ratified conventions and 13 pending conventions between the United States and various foreign countries. These conventions are listed in App.C, *infra*.

[37] The problem of multiple taxation of foreign commerce was highlighted during World War I because of the taxes imposed by the world community to finance the war. The League of Nations quickly took up the problem of multiple taxation of international commerce and it published several reports in an effort to establish uniform tax principles. The international tax report of the League

It is obvious, we think, that the United States can speak with "one voice" in regulating foreign commerce only if the States and political subdivisions that choose to tax income from foreign commerce are required to recognize and implement the basic policies which the Federal Government applies in taxing such income. The avoidance of double taxation of foreign-source income is such a policy. Moreover, the Federal Government's policy in this area is clearly in accord with the "custom of nations." See *Japan Line*, 441 U.S. at 447, 454. Virtually every developed non-communist country in the world has an income tax structure which is designed to avoid double taxation of interna-

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of Nations adopted in 1943 by its Fiscal Committee embraced the concepts of taxation at source, with the obligation to relieve taxpayers from multiple taxation shifting to the country of residence. Model Bilateral Convention for the Prevention of International Double Taxation and Fiscal Evasion, League of Nations Document. See Ke Chin Wang, *International Double Taxation of Income: Relief Through International Agreement 1921-1945*, 59 Harv. L. Rev. 73, 81-97 (1945).

Since World War II, the OECD, of which the United States is a member, has continued to promote model conventions to prevent multiple taxation of international commerce. Article 10 of the 1963 model convention provides that dividends may be taxed in either the country of source or the country of the shareholder's residence. If the country of source imposes a tax, however, the burden is shifted to the country of residence to provide relief. Articles 23A and 23B. A similar principle is applicable to interest income. Article 11. The model convention included in the 1977 Report of the OECD Committee on Fiscal Affairs contains similar provisions. The United States Department of Treasury has adopted the OECD model convention as its basic negotiating position in bilateral income tax treaty negotiations. 46 Fed. Reg. 37432 (July 20, 1981).

tional income by effectively giving taxing priority to the source nation.[38]

Because this policy is firmly embedded in federal law and treaties, and clearly constitutes the custom of nations, we think it is constitutionally intolerable for the States to disregard it. Put differently, we believe that any State choosing to include foreign-source income in its apportionable tax base has a constitutional obligation to devise some mechanism which will effectively prevent the imposition of a second tax on any income which has already been taxed abroad by the source nation.[39]

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[38] This is generally done either by excluding the foreign-source income from the tax base altogether, or by taxing it and then allowing a credit for the tax imposed by the source nation. See Dr. D. Juch, "General Report on Unilateral Measures to Prevent Double Taxation," *Cahiers de Droit Fiscal International*, Vol. LXVI b, International Fiscal Association, XXXV Congress, Berlin (1981). As stated at pp. 18-19 of that report, and in the more detailed national reports which follow in the same volume, Argentina, Australia, Austria, Belgium, Brazil, France, the Netherlands, Norway, Portugal, and Switzerland are among the countries using a full or partial exemption system; and Canada, Colombia, Denmark, Germany, Finland, Japan, Spain, Sweden, the United Kingdom, and the United States are among the countries using the credit system.

[39] The fact that bills regulating state taxation of foreign income have been introduced in Congress, but not enacted, should not prevent this Court from requiring the States to act in a manner consistent with long-standing, consistently implemented federal policy. Congressional failure to act should not be viewed as tacit approval of current state practices where, as here, it can be shown that those practices are fundamentally at odds with the Federal Government's taxing policy with respect to foreign income as evidenced by laws which Congress *has* enacted and treaties which the Senate *has* ratified. State action which imposes a clear burden on foreign commerce by subjecting foreign income to double tax is contrary to the Foreign Commerce Clause and should therefore be pro-

Idaho's taxing statute does not comport with federal policy, either in concept or in practice. Idaho makes no effort to reflect, in any way, the foreign withholding taxes imposed on foreign-source dividends, interest, royalties, or other similar income items received by Idaho residents. Thus, if M.I.M. declares a $100 dividend to appellant, withholds the $15 of Australian tax which appellant owes, and remits the remaining $85 to appellant, Idaho will include the full $100 in appellant's apportionable business income. Moreover, Idaho will tax a portion of that amount without allowing any credit or other offset for the $15 Australian withholding tax borne by appellant on the same income,

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hibited by this Court until and unless Congress takes affirmative action to sanction it.

In *Mobil*, this Court stated (445 U.S. at 448) that "[a]bsent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." However, this statement was clearly made in the context of a discussion which was *not* dealing with "problems of duplicative taxation at the international level" but was, instead, focusing on "the wholly different sphere of multiple taxation among our States." *Ibid.* Where, however, foreign commerce is involved, this Court has made it clear that the States are not "free to impose demonstrable burdens" on such commerce simply because Congress has not "pre-empted the field by affirmative regulation." *Japan Line*, 441 U.S. 454. This is because:

> [I]t long has been "accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests." [Citation deleted; *Ibid.*]

and without making any meaningful adjustment to the regular Idaho apportionment factors.[40]

This Court cannot prevent Australia and other foreign countries from continuing to tax appellant on 100% of the dividends and interest it receives from those countries. See *Japan Line*, 441 U.S. at 447-448. Accordingly, inclusion of the dividends and interest in appellant's apportionable income for state tax purposes, without offsetting relief, inevitably means that more than 100% of the income will be taxed. The resulting double taxation imposes an actual burden on foreign commerce which is significant now[41]

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[40] In addition to reporting the $100 dividend for federal tax purposes, appellant must, if it elects to claim a "deemed paid" foreign tax credit for Australian income taxes imposed on M.I.M., treat an amount equal to that deemed paid credit as additional dividend income under the "gross-up" provisions in section 78 of the Internal Revenue Code. As an administrative matter, Idaho does permit appellant to exclude from its apportionable business income any "gross-up" reported on appellant's federal return. However, this adjustment does nothing to cure the problem with respect to the actual dividend of $100, which is subject to tax in Idaho as well as in Australia.

[41] There are presently at least 27 States which apportion dividend income. See Appendix F to the Jurisdictional Statement filed in *Mobil*, a copy of which is reproduced in J.S.App.F. In 1974, the latest year for which federal tax return statistics are available, United States corporations claiming a foreign tax credit received foreign-source dividends of over $6.1 billion. 1974 Statistics of Income, International Income and Taxes, Foreign Tax Credit (GPO, Washington, D.C. 1980), p. 9, col. 2.

and could become appreciably greater in the near-term future.[42] We urge this Court to eliminate that burden by applying the principles of *Japan Line* to state income as well as property taxes.

CONCLUSION

For the foregoing reasons, this Court should reverse the decision below and remand the case to the Supreme Court of Idaho for further proceedings in conformity with this Court's opinion.

Respectfully submitted,

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[42] During the last decade, major American-based industrial companies have derived a steadily increasing percentage of their total earnings from overseas operations conducted through foreign subsidiaries and affiliates; the earnings which these companies have repatriated from direct investments abroad have increased fivefold in the last decade "to an estimated $41 billion for 1981." Janssen, *Tracking a Trend,* Wall St. J., Mar. 11, 1981, p. 56. There is every reason to expect this trend to continue.